15 May 2007

Creaming it

Commodity price impulses in NZ and Australia

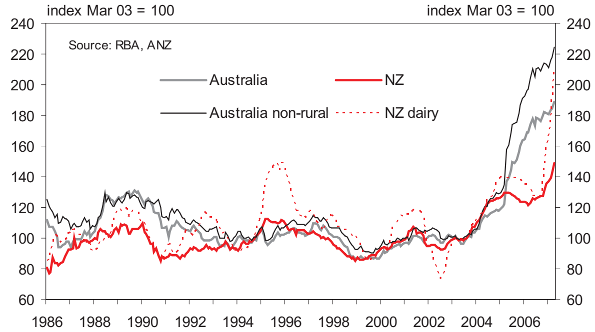
- **Both NZ and Australia have been enjoying booming commodity prices, which we expect will endure.**
- **The net stimulus for Australia is larger than for NZ, though ours is still hefty.**
- **Commodity price and other economic developments will favour the AUD over the NZD.**
- **However, the stronger commodity price outlook will generally see the NZD higher for longer, and also improves the growth outlook.**

In recent years both New Zealand and Australia have been enjoying a boom in the price of their export commodities. This note takes a quick look at how the economic impulse from this boom may differ in the two countries.

New Zealand's commodity exports are 75% "soft" agricultural products, while Australia exports mainly "hard" commodities such as minerals. In NZ dairy's share has grown, with milk-based products now making up almost a third of our commodity exports by value.

Prices for the two countries' commodities tend to move broadly together due to common demand factors. However, our cycles can diverge. Figure 1 shows that this has most strikingly been the case in the past two

Figure 1: Australia and NZ commodity price indices (SDR[1] terms)



[1] IMF Special Drawing Rights – a synthetic international currency used to reduce the impact of USD volatility on the index.

Table 1: Drivers of the recent dairy price boom

Driver	Comment
Strong world demand	Global milk consumption is currently increasing by around 3%, roughly NZ's entire production, every year. This reflects strong global economic growth, which is expected to continue for a couple of years yet. In addition, part of this is structural: changing Asian and Latin American diets. China has recently started sponsoring milk in schools programs.
Australian drought	The reduction in Australian exports in 2006 kicked off the recent price increase. Experience suggests the contraction in production will have a permanent component.
Limited production growth in the US	The US is the world's largest exporter of milk powder. However, increased ethanol production has seen grain feed costs rise so sharply that expanding milk production is currently not profitable even at these record prices. Biofuels demand is expected to persist.
Reductions in EU subsidies	Production is reducing due to changes in subsidies allocation. European skim milk powder exports in 2006 were almost 60% lower than the previous year, though this also reflects less destocking.
Low world stocks	The US government has no remaining dairy stocks to sell. European warehouses are also empty, versus some 200,000 tonnes of milk powder in storage in 2003. Current prices are a strong signal to increase production (for grass-based producers), and South American and Asian producers are heeding the call. However, time-to-breed constraints give some breathing space.

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years. The recent major drivers have been base metal prices in Australia and milk powder prices in NZ (up 60% in six months).

Relatively little product is sold at these spot prices – much is pre-sold in long-term contracts. To fully impact on returns, therefore, the boom must persist. While recent developments in milk powder prices have been accompanied by a sense of wondrous disbelief, the stage is set for a reasonably long-lasting boom, as many of the factors this time are structural (see Table 1). Overall, growth in demand is expected to outstrip supply for at least another year.

The driver in the Australian minerals price story is much higher demand from China and other emerging markets. Short of a dramatic collapse in Asian industrialisation, it seems that this strong demand will be persistent. In addition, the resulting supply shortages may be more enduring than in the dairy industry, as it takes considerably longer to dig a mine than breed a cow.

How much is being translated into local returns?

The currency

Local returns depend not only on world prices, but also on the exchange rate at which receipts are converted. Both the Australian and NZ dollars have strengthened in recent times, partly in response to the commodity price boom. This buffering response is desirable: when commodity prices drop, an exchange rate fall softens the blow for exporters. When commodity prices lift, an exchange rate rise diffuses the benefits of the terms of trade improvement throughout the economy, by making imports cheaper. Figures 2 and 3 below show that both the NZ and Australian trade-weighted exchange rates (TWIs) generally move roughly in tandem with each country's commodity prices (except for 2000-01). However, the NZ TWI has matched the recent boom far more closely than has the Aussie TWI.

Figure 2: NZ TWI and commodity prices

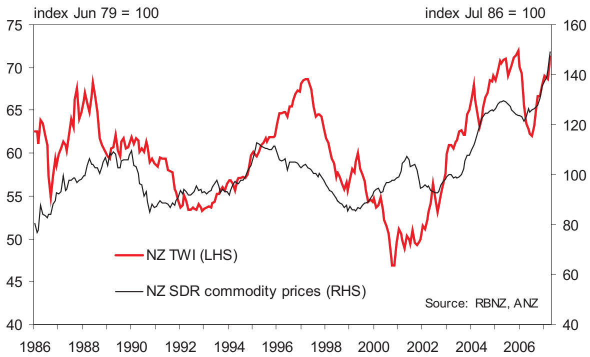
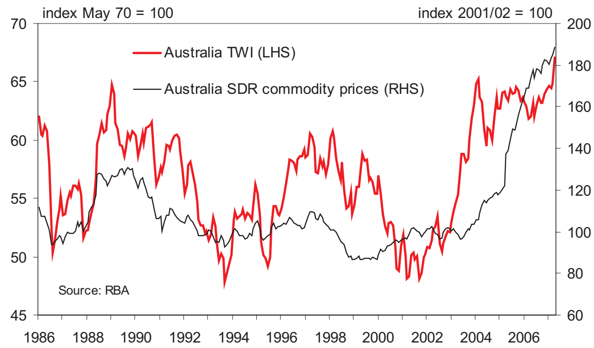
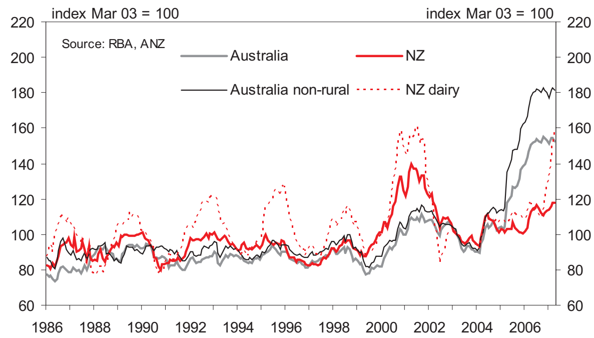


Figure 3: Australia TWI and commodity prices



This means that commodity returns in local currency terms have risen much more in Australia (Figure 4). (But of course, this also means that they are receiving less benefit in terms of cheaper imports).

Figure 4: Australia and NZ commodity price indices (local currency terms)



An additional complicating factor is hedging; the actual exchange rate at which receipts are repatriated will lag these spot rates. While details aren't public, it is known that Fonterra hedge to a considerable extent.

The length of contracts

The Fonterra chairman's public comment regarding likely payouts of at least \$5/kg/ms next season suggests that some of these high spot prices have already been locked in. As Figure 4 shows, even if the high exchange rate has been locked in as well, the combined effect is still very healthy returns. Returns at this level were last seen in 2001 when the NZ exchange rate was 40-45c against the USD. Anecdotal evidence suggests that price contracts for hard commodities can be considerably longer than for soft commodities, which would cause further delays in Australia benefiting from the boom. However, the Australian price boom was off the mark a couple of years before New Zealand's.

How much of an impact are these high returns

likely to have?

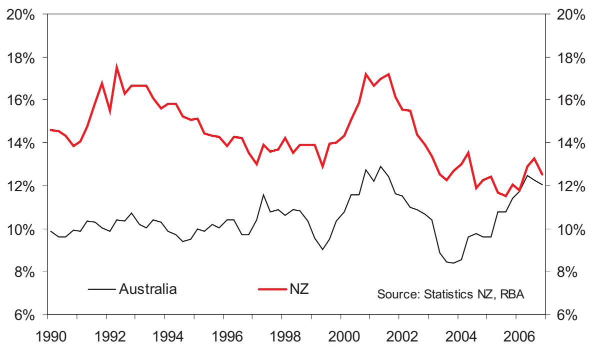
All up, Australian local currency returns have surged more than NZ's. But how much of an economic boost is this likely to provide?

The openness of the economy

Australian commodities make up a greater share of their total exports than in NZ (57% vs. 44%). However, NZ is a more open economy, with exports comprising some 30% of GDP versus Australia's 20%. Combined, this makes commodity exports as a percent of GDP currently quite similar in the two economies, at around 12% by value (Figure 5):

A rough measure of the economic impulse is returns

Figure 5: Commodity exports as a % of GDP by value



growth multiplied by this share. As mentioned, because of a lack of information on hedging and price contracts this number will be approximate and likely overstated. In addition, it excludes the spin-offs to the economy from increased jobs and investment from expanding production. However, it is still useful for a rough comparison. Table 2 below shows the average impulse over the last two years.

Table 2: Impulse over 2005-2006

	Average price growth (%)	Average % of GDP	Impulse (% of GDP)
Australia	14.7	11.4	1.7
NZ	7.2	12.3	0.9

The Australian commodity economic impulse is much bigger. However, a crucial question is to whom the wealth is accruing. Under Fonterra's cooperative ownership structure, foreigners can only own a share of our dairy industry in so far as they are milk producers in NZ, a very small proportion. On the other hand, the mining industry in Australia is roughly half foreign-owned. This means half of their profits head overseas. Nonetheless, the benefits of the increased employment and wages will still mostly remain in Australia, and it is fair to conclude that their economic impulse is indeed considerably larger than ours.

The Reserve Bank of Australia's May 2007 *Statement* said:

> The global expansion has provided continued support to international commodity prices. … How long the strength in commodity prices might persist is unknown. At some point, increased supply from major commodity producers can be expected to limit price increases, but forecasts of any such dampening effect have generally been pushed further into the future as prices have continued to rise. … Australia's terms of trade have risen over the past four years by around 40 per cent. This is providing a substantial boost to incomes, spending and activity.

The Reserve Bank of New Zealand has given air-time to commodity prices in three of their past four *Statements*, and given the recent increase in the Fonterra payout they are likely to continue to keep a close eye on developments. A 20c increase in the payout per kilo of milksolids to $4.35 this season amounts to a $250m injection into the economy: around $22k per dairy farmer, or 0.2% of annual GDP. A $5/kg/ms payout next year would be worth about another $850m: some $73k per farmer, or 0.5% of GDP. And the final payout may well be bigger still. It's huge.

What does it mean?

For the currency

The stars favour the AUD over the NZD in coming years:

- The Australians have experienced a larger terms of trade stimulus.
- Our currency has already fully priced in our commodity price gains; the AUD doesn't appear to have.
- Australia has already experienced its housing market correction, while NZ's is still looming.
- *Consensus* forecasts are for growth around 0.5% higher in Australia than in NZ over the next couple of years.

Overall, higher growth in both aggregate demand and supply in Australia should see AUD outperform the NZD over coming years. We forecast the NZD-AUD cross rate to trough around 75c at the end of 2009.

On the other hand, the anticipated ongoing strength in our commodity prices has caused us to revise up our exchange rate forecasts against other currencies such as the US dollar.

For growth

Australasia Inc just got a whole lot richer, and the good times for both countries may now roll on considerably longer.

Australia remains the "lucky country" (drought excepted!) and their current terms of trade boom could reasonably be compared to discovering moderate oil reserves. Boom times in Aussie are a mixed blessing for NZ: they take more of our exports, but more of our labour pool as well. Long-term departures to Australia have been rising both in total and as a share of total departures since 2003.

For NZ, this term of trade surge will help deliver a much-needed reduction in our huge and unsustainable current account deficit. Unfortunately, there will be some collateral damage. We are experiencing a mini version of "Dutch disease", where a wildly successful resource export crowds out other exports via a broadly appreciated currency. Fortunately our increasingly specialised export basket is currently occupied by a cash cow.

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